

REPORT OF EXAMINATION
OF THE
MERCURY INSURANCE COMPANY

AS OF
DECEMBER 31, 2003

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Los Angeles, California
October 22, 2004

Honorable John Garamendi
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

MERCURY INSURANCE COMPANY

(hereinafter also referred to as the Company) at its branch office located at 4484 Wilshire Boulevard, Los Angeles, California 90010. The Company's statutory home office is located at 555 West Imperial Highway, Brea, California 92821.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2000. This examination covers the period from January 1, 2001 through December 31, 2003. This examination was conducted pursuant to the National Association of Insurance Commissioners' plan of examination. The examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions within the examination period, and an evaluation of the assets and a determination of liabilities as of December 31, 2003, as deemed necessary under the circumstances.

This examination was conducted concurrently with examinations of the Company's parent, Mercury Casualty Company and its affiliates, California Automobile Insurance Company, and California General Underwriters Insurance Company, Inc.

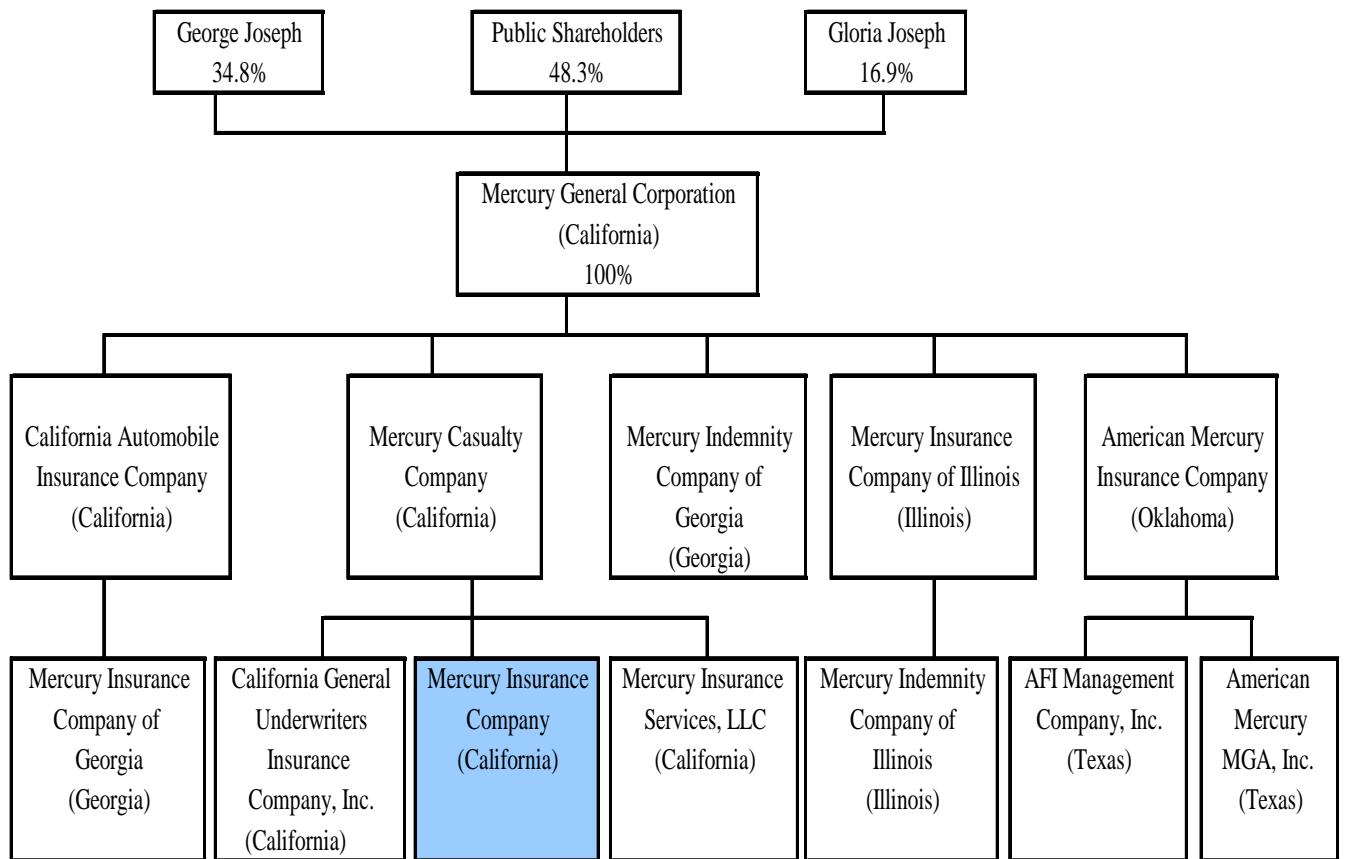
In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of company; business in force by states; loss experience; and sales and advertising.

COMPANY HISTORY

The Company was incorporated under the laws of the State of California on November 20, 1972, and commenced business on July 1, 1978. During the examination period, the Company paid cash dividends to its parent in the amount of \$114 million.

MANAGEMENT AND CONTROL

The Company is a wholly-owned subsidiary of Mercury Casualty Company (MCC). MCC, in turn, is a wholly-owned subsidiary of Mercury General Corporation (MGC), a holding company. The controlling stockholders, George Joseph and Gloria Joseph, own 34.8% and 16.9%, respectively, of the stock of MGC, with the remaining 48.3% held by public shareholders. The following organizational chart depicts the interrelationships of the companies within the holding company system:



Management of the Company is vested in a ten-member board of directors elected annually. A listing of the members of the board and principal officers serving on December 31, 2003 follows:

Directors

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Nathan Bessin Los Angeles, California	Senior Partner J. Arthur Greenfield & Company
Bruce A. Bunner Weston, Connecticut	President Financial Structures, Ltd.
Michael D. Curtius Carlsbad, California	Executive Consultant Mercury General Corporation
Richard E. Grayson Murrieta, California	Retired
George Joseph Los Angeles, California	Chairman and Chief Executive Officer Mercury General Corporation
Charles E. McClung Carlsbad, California	Chairman McClung Insurance Agency
Donald P. Newell Rancho Santa Fe, California	Senior Vice President and Secretary SCPIE Holdings, Inc.
Bruce E. Norman Los Angeles, California	Vice President, Marketing Mercury General Corporation
Donald R. Spuehler Los Angeles, California	Retired Partner Law Firm of O'Melveny & Meyers, LLP
Gabriel Tirador Los Angeles, California	President Mercury General Corporation

Principal Officers

<u>Name</u>	<u>Title</u>
George Joseph	Chairman, Chief Executive Officer and Treasurer
Gabriel Tirador	President
Cooper Blanton, Jr.	Executive Vice President
Judy Walters	Vice President, Corporate Affairs and Corporate Secretary
Theodore Stalick	Vice President and Chief Financial Officer

Management Agreements

Management Agreement: The Company operates under a management agreement with Mercury Insurance Services, LLC (MIS), a subsidiary of MCC. Prior to January 1, 2001, these services were provided by Mercury General Corporation. Under this agreement, MIS performs all operating functions such as marketing, underwriting, rating, policy issuance, claims, data processing, and pays all the operating expenses including, but not limited to rent, supplies, salaries, legal and claim adjustment expenses. The Company directly pays for losses, premium taxes, audit fees, and various fees and assessments. Management fees are based on actual expenses incurred for services provided to the Company. California Department of Insurance (CDI) approved this agreement on January 1, 2001. The Company paid the following fees during the examination period:

<u>Year</u>	<u>Amounts</u>
2001	\$126,847,875
2002	\$138,994,346
2003	\$160,614,799

The Company also operates under a premium collection and loss payment arrangement with MCC and California Automobile Insurance Company. Under the arrangement, MCC collects the premium and pays claims and commissions on behalf of the other companies. The net amount is settled on a monthly basis. Interest earned on the daily excess cash is allocated among the three companies based

on net premiums collected each month. An agreement that governs this arrangement is being drafted and will be submitted to the CDI for approval as required by California Insurance Code Section 1215.5.

Tax Allocation Agreement: The Company and its ultimate parent file a consolidated federal income tax return under the terms of a Tax Allocation Agreement. The Company's tax liability, pursuant to the agreement, is the same as it would have been had it filed on a separate stand-alone basis.

TERRITORY AND PLAN OF OPERATION

The Company is licensed as a multiple line fire and casualty insurer in the State of California. Writings are limited to preferred private passenger automobile risks in the State of California on a direct billing basis. Business is produced by approximately 1,000 agents. The agents, most of whom also represent one or more competing insurance companies, are independent contractors selected and appointed by the Company. In 2003, the Company wrote direct premiums of \$1 billion in California.

The Company's headquarters is in Brea, California. The Company has branch offices in the following cities:

Anaheim
Rancho Cordova
Santa Ana

Brea
Rancho Cucamonga
Valencia

Los Angeles
San Clemente
Westlake Village

Morgan Hill
San Diego

REINSURANCE

Assumed

The Company did not assume any reinsurance business during the period covered by the examination.

Ceded

The Company did not cede any reinsurance business during the period covered by the examination.

ACCOUNTS AND RECORDS

This examination experienced some minor difficulties obtaining supporting documentation for certain balance sheet accounts. It is recommended that the Company maintain documentation to support all financial statement accounts. The documentation should be prepared in sufficient detail as to allow for a full and complete audit trail from the Annual Statement to individual record.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2003

Underwriting and Investment Exhibit for the Year Ended December 31, 2003

Reconciliation of Surplus as Regards Policyholders
from December 31, 2000 through December 31, 2003

Statement of Financial Condition
as of December 31, 2003

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$964,856,241	\$964,856,241	(1)
Stocks:			
Preferred stocks	59,429,856	59,429,856	(1)
Common stocks	75,890,263	75,890,263	(1)
Cash and short-term investments	128,859,837	128,859,837	(1)
Other invested assets	1,368,979	1,368,979	
Investment income due and accrued	13,937,296	13,937,296	
Premiums and considerations:			
Uncollected premiums and agents' balances in the course of collection	98,602,861	98,602,861	
Net deferred tax asset	26,319,760	26,319,760	
Receivable from parent, subsidiaries and affiliates	18,066,226	18,066,226	
Total assets	<u>\$1,387,331,319</u>	<u>\$1,387,331,319</u>	
<u>Liabilities, Surplus and Other Funds</u>			
Losses		\$ 272,841,578	(2)
Loss adjustment expenses		101,675,000	(2)
Commissions payable, contingent commissions		24,164,721	
Other expenses		992,570	
Taxes, licenses and fees		5,655,806	(3)
Current federal and foreign income taxes		6,430,000	
Unearned premiums		260,625,507	
Advance premiums		20,497,690	
Ceded reinsurance premiums payable		200,000	
Drafts outstanding		38,733,866	
Payable to parent, subsidiaries and affiliates		4,774,797	
Payable for securities		5,451,992	
Aggregate write-ins for liabilities		168,398	
Total liabilities		742,211,925	
Common capital stock	\$ 10,000,000		
Gross paid-in and contributed surplus	82,503,673		
Unassigned funds (surplus)	<u>552,615,721</u>		
Surplus as regards policyholders		<u>645,119,394</u>	
Total liabilities surplus and other funds		<u>\$1,387,331,319</u>	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2003

Statement of Income

Underwriting Income

Premiums earned		\$1,034,066,711
Deductions:		
Losses incurred	\$ 585,065,075	
Loss expense incurred	122,704,781	
Other underwriting expenses incurred	<u>279,434,078</u>	
Total underwriting deductions		<u>987,203,934</u>
Net underwriting gain		46,862,777

Investment Income

Net investment income earned	\$ 55,095,391	
Net realized capital gains	<u>5,498,316</u>	
Net investment gain		60,593,707

Other Income

Net loss from agents' balances charged off	\$ <u>(7,424)</u>	
Total other income		<u>(7,424)</u>
Net income before federal income taxes		107,449,060
Federal income taxes incurred		<u>(25,339,000)</u>
Net income		<u>\$82,110,060</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2002		\$ 539,487,877
Net income	\$ 82,110,060	
Change in net unrealized capital gain	18,040,648	
Change in net deferred income tax	15,533	
Change in nonadmitted assets	<u>5,465,275</u>	
Change in surplus as regards policyholders		<u>105,631,516</u>
Surplus as regards policyholders, December 31, 2003		<u>\$ 645,119,394</u>

Reconciliation of Surplus as Regards Policyholders
from December 31, 2000 through December 31, 2003

Surplus as regards policyholders, December 31, 2000, per Examination			\$511,303,284
	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>	
Net income	\$ 190,549,004	\$	
Net unrealized capital gains	14,417,888		
Change in net deferred income tax	15,927,568		
Change in nonadmitted assets	1,839,055		
Cumulative effect of changes in accounting principles	16,316,613		
Dividends to stockholders		114,000,000	
Aggregate write-ins for gains in surplus	<u>8,765,981</u>		
Totals	<u>\$247,816,109</u>	<u>\$114,000,000</u>	
Net increase in surplus as regards policyholders			<u>133,816,109</u>
Surplus as regards policyholders, December 31, 2003, per Examination			<u>\$645,119,394</u>

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Bonds, Stocks and Cash and Short-Term Investments

Effective September 3, 2003, the Company terminated its Custodial agreement, and replaced it with a new Custodial agreement. The new agreement is between the Company and BNY Western Trust Company. The Company failed to submit this agreement to the California Department of Insurance (CDI) for review and approval under California Insurance Code (CIC) Section 1104.9. It is recommended that the Company submit this agreement to the CDI for review and approval pursuant to CIC Section 1104.9

(2) Losses and Loss Adjustment Expenses

The December 31, 2003 for loss and loss adjustment expense reserves were evaluated by a Casualty Actuary from the California Department of Insurance. Based on the analysis performed, the Company's reserve for loss and loss adjustment expense reserves as of December 31, 2003 were deemed reasonable.

(3) Taxes, Licenses and Fees

The CDI made a determination that starting with tax year 1998, the Company began to use premiums received instead of premiums written as the premium tax base. The CDI proposed deficiency assessment for each year was \$1,568,074 and \$38,208 for years 1998 and 1999, respectively. The Company filed a Petition for Redetermination while it continued to use premium received instead of premiums written as the premium tax base. The CDI has sent the California State Board of Equalization the above information for further processing. The Company is contesting the CDI proposed deficiency assessments. A hearing on this matter is currently pending.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Management Agreement (Page 5): It is recommended that the Company submit a premium collection and loss payment agreement with the parent, Mercury Casualty Company to the California Department of Insurance for approval as required by California Insurance Code (CIC) Section 1215.5.

Accounts and Records (Page 7): It is recommended that the Company maintain documentation to support all financial statement accounts.

Bonds, Stocks and Cash and Short-Term Investments (Page 11): It is recommended that the Company implement procedures to ensure compliance with CIC Sections 1104.9 and 1215.

Previous Report of Examination

Corporate Records (Page 6): It was recommended that the Company comply with the CIC Section 735 which requires the Company to inform the board members of the receipt of the examination report and enter that fact in the board minutes. The Company complied with this recommendation.

ACKNOWLEDGEMENT

The courtesy and cooperation extended by the officers and employees of Mercury Insurance Services, LLC during the course of this examination are hereby acknowledged.

Respectfully submitted,

Duane Armstrong, CFE
Examiner-In-Charge
Senior Insurance Examiner
Department of Insurance
State of California